

September 8, 2005

TO: CARLI Board of Directors via CARLI Finance Committee

FROM: J. David Stewart
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SUBJECT: Economic and Budget Update Report (Informational Item)

The following information has been compiled from multiple published sources and is intended to provide an update on the national and state economy, the latest available Illinois revenue forecasts and status of FY 2006 state budget.

One caveat: by and large these economic measures do not yet reflect the economic impacts of Hurricane Katrina. One government agency, the Congressional Budget Office, predicts that Katrina's aftermath will trim one percent from economic growth in the second half of the year, that job losses of 400,000 or more will occur in the coming months, and that September gas prices will average 40 % higher than before the hurricane hit.

National Economy

At this time, the national economy continues to show generally positive trends, but there are some underlying concerns as illustrated by some of the most recent economic data available.

- Short term interest rates held steady at 3.5%. Economists had been speculating that the Federal Reserve would increase this rate by an additional .25% at its September 20 meeting, but now a growing number of economists feel that the Federal Reserve will hold the rate steady to ease the economic impact of hurricane Katrina. Federal funds rates of 3.5% are at their highest level in 4 years. These baseline short-term interest rate changes affect prime interest rates, mortgage and revolving credit card rates, ARMS and other variable rate types of interest adjusted debt.
- Crude oil and gasoline prices fluctuated during August with the uncertainties of Katrina's impact on available production and supply. Prices exceeded \$70 a barrel and \$3 a gallon, respectively, in Katrina's wake, but these prices have dropped somewhat since. This affects both consumers directly and indirectly through higher transportation costs and surcharges paid.
- Consumer prices have been rising at a faster rate in recent months as a strengthening in economic activity raises inflationary concerns. This is in sharp contrast to conditions two years ago when the major issue at that time was fear of deflation, or falling prices. In July 2005, overall consumer prices were 3.2% higher than a year ago while the core rate, excluding food and energy prices, was up at 2.1%.

- New single-family housing starts have leveled out at a record pace after a sharp rising trend that has existed over the past four years. Most attention has centered on the extreme rise in home appreciation that has occurred in recent years. There is some evidence that overall prices may be stabilizing. While average sales prices in June 2005 were up from a year ago, median sales prices were about flat with that seen a year earlier.
- Productivity growth has slowed, increasing at an annual rate of 1.8% in the April-June quarter, down from a 3.2% increase in the first three months of the year. The 1.8% increase was the slowest increase since the summer of 2004.
- Unemployment claims nationally have been dropping, dipping to a four-year low of 4.9% in August. The economy added 169,000 new jobs in August.

Illinois Economy

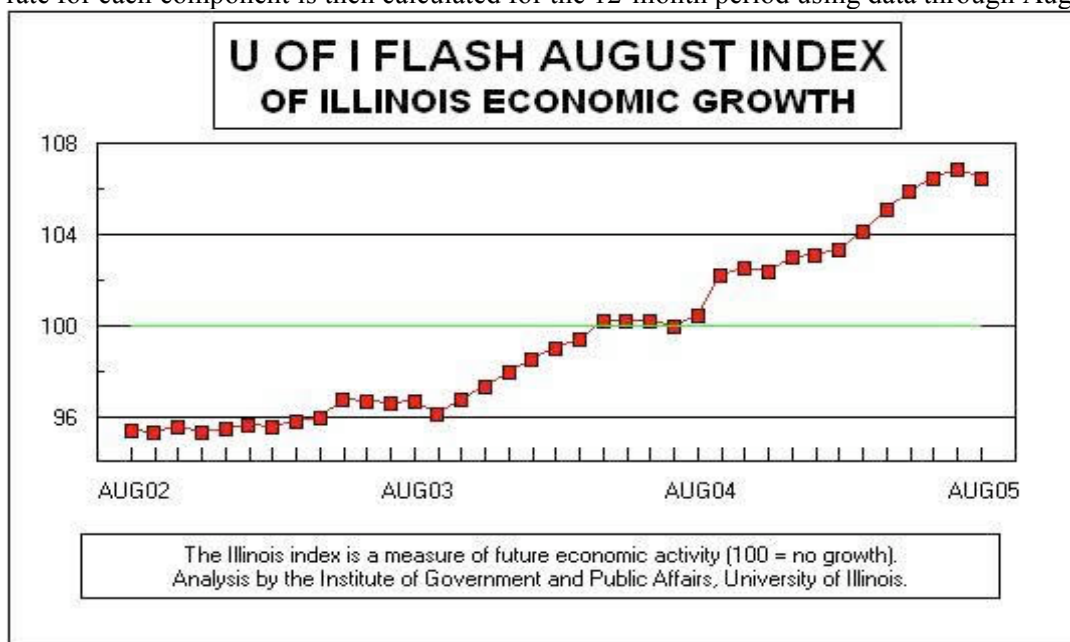
In general, the Illinois economy is showing steady improvement, although at a slower rate than in the recent past. Real economic indicators point to solid progress in economic recovery: building permits are up from last year and the most recent 4 month average shows them to be up by over 12% over the comparable period last year. Illinois' new claims for unemployment compensation are down and hours worked in manufacturing are improving. When compared to July data, August receipts for state sales tax increased moderately, individual income tax receipts remained stable, while corporate tax receipts decreased slightly.

The University of Illinois Flash Economic Index continued its strong performance, although the rate of expansion slowed somewhat. The Flash Index was 106.5 for August, down from the 106.9 reading in July, and equal to the 106.5 level recorded for June 2005. Just a year ago, the Index was at 100.5, slightly above the threshold between economic growth and decline. In August 2005, all components of the Index were up in "real" (inflation-adjusted) terms from the same month a year ago.

J. Fred Giertz, the Illinois economist who compiled the data stated: "The August reading is still in strongly positive territory. It indicates that the Illinois economy is expanding, although at a slightly slower rate than in July." However, Giertz expressed some caution about the potential impacts of hurricane Katrina on the Illinois economy: "The September index should give us more information on whether the state economy is, in fact, slowing and also the impact of higher fuel prices and other damage caused by Hurricane Katrina." "

The Flash Index is a weighted average of Illinois growth rates in corporate earnings, consumer spending and personal income. Tax receipts from corporate income, personal income and retail sales are adjusted for inflation before growth rates are calculated. The growth

rate for each component is then calculated for the 12-month period using data through August



State Revenues

Late last month the Illinois Commission on Government Forecasting and Accountability (http://www.ilga.gov/commission/cgfa/cgfa_home.html) issued its *FY 2006 Economic Outlook and Revenue Estimate*. The Commission estimates that base FY 2006 revenues will be \$27.740 billion, an increase of 2.3% (\$600 million) over FY 2005. One section of the report provides a detailed summary of the Commission's estimates for the larger sources of revenue, as follows:

- **Personal income tax-** Gross personal income taxes are estimated at \$9.217 billion in FY 2006. That figure assumes base receipts will rise 5.0%, but due to the impact of the Voluntary Compliance Program (VCP) in FY 2005, the effective rate of growth is a lower 3.9%, which translates into an increase of \$344 million. The estimate also incorporates the newly established refund percentage of 9.75%, down slightly from last year's 10.0% rate. As a result, on a net of refund basis, personal income tax receipts are expected to increase \$339 million or 4.2%.
- **Corporate income tax-** Gross corporate income taxes are estimated at \$1.614 billion. That forecast assumes base growth of 7.0%, but due to the impact of the VCP, the effective rate of growth is a lower 4.3%, which represents an increase of \$66 million. The estimate incorporates the new refund percentage of 20.0%, down from last year's 24.0% rate. As a result, on a net of refund basis, corporate income tax receipts are expected to increase \$119 million or 10.2%.
- **Sales tax receipts-** Sales tax receipts are estimated to be \$6.890 billion, or 4.5% higher than last year's actual. The forecast assumes growth similar to what was experienced in the prior year.
- **Public utility tax-** Public utility tax receipts are forecast to be \$1.072 million in FY 2006. The estimate represents a modest increase of \$16 million or 1.5%.
- **Cigarette tax-** The estimate of cigarette tax is \$405 million and represents a \$45 million decline from last year. The drop off is due to the temporary change in cigarette tax distribution that took place last year (worth \$50 million). Slightly offsetting that decline is an expected \$5 million from a new distribution change ordered under P.A. 94-91.

- **Liquor gallonage tax-** The estimate of liquor tax is \$150 million or a \$3 million increase over FY 2005. While last year enjoyed a \$20 million increase due to the elimination of an earlier tax protest, receipts growth should once again flatten.
- **Inheritance tax-** Inheritance tax is expected to dip slightly to \$300 million in FY 2006. A number of large estate settlements experienced last fiscal year cannot be relied on to be repeated. In addition, the decoupling from the federal phase-out has now been fully annualized and will no longer increase revenues.
- **Insurance taxes and fees-** The estimate of insurance taxes and fees is \$342 million, reflecting no growth over the previous fiscal year. Last year, insurance receipts fell approximately 5.5% due to higher regular income tax payments (allowed as a deduction against owed insurance taxes). FY 2006 should once again see good regular income tax payments, which should serve to retard any growth from this source.
- **Corporate franchise taxes and fees-** The forecast is \$185 million and reflects a modest increase of \$4 million or 2.2% over the previous fiscal year.
- **Interest income-** Last year interest earnings increased nearly 33% as interest rates continually improved. Similar growth is expected in FY 2006 as rates of return continue to improve. The forecast assumes growth of \$23 million or 31.5%.
- **Cook County Intergovernmental Transfer-** The IGT is expected to begin falling over the coming fiscal years due to the federal government phasing out the “hyper-payments” that are currently used under this funding mechanism. As a result, the transfer is expected to decrease by \$93 million in FY 2006.
- **Other sources-** The revenue from other sources to the general funds is expected to fall \$22 million in FY 2006. The decline is anticipated due to lower Build Illinois general reserve account transfers as well as an anticipated drop in commercial distribution fee revenue stemming from P.A. 93-1033.
- **Lottery transfers-** Lottery transfers are expected to rise \$11 million to \$625 million in FY 2006. Some growth is expected due to increased lottery drawings and additional retailers.
- **Riverboat transfers and direct receipts-** Revenues from riverboat gaming are forecast to dip slightly by \$11 million. Essentially, while the graduated tax rates were allowed to decrease per current law, SB 316 institutes a hold harmless provision that will mitigate any loss associated with the rate change. The slight decrease is anticipated because SB 316 also reduces the admissions tax, and that component is not under the hold harmless provision.
- **Other transfers-** In FY 2006, other transfers to the general funds are expected to fall \$129 million from the prior fiscal year, primarily reflecting lower statutory funds sweeps and anticipated fund chargebacks.
- **Federal Sources-** Federal sources are estimated to increase a modest 2.1% or \$100 million, reflecting appropriations and anticipated spending.

While it appears overall that forecasted state revenues for FY 2006 are reflecting moderate improvement over the previous year, the expenditure demands for state revenues have been growing at a far faster pace with no immediate relief in sight. Given the current level of uncertainty, we will continue to monitor national and state economic patterns closely in the coming months. A comparison of state revenue forecasts to actual yields will be available shortly after the first quarter of FY 2006, which ends on September 30, 2005. Please let me know if you have any questions.